
FIRSTGLOBAL
GROUP

# GLOBAL BRIEF

January 2017

## Editorial comment

I believe most will agree with a sigh of relief that 2016 is behind us.

As we are just warming up to a new year, armed with fresh minds and new years resolutions, it may be prudent to accept that the economic world is not completely out of the woods as yet. Two of 2016's news-dominating events (BREXIT and US ELECTIONS) have both rendered unexpected outcomes and may have far-reaching implications for many countries and markets going forward. These will take time to gain traction and reduce the uncertainties surrounding policies and how it will affect markets – also in other parts of the world.

Locally we have been fortunate to avoid another much feared credit downgrade and the municipal election outcomes have certainly gone a long way to restoring some market confidence, with clear indications of less corruption and better service delivery in three more key metropolitan regions vital for economic growth. With uncertainty still clouding the political landscape, we can only hope that 2017 will bring more clarity with the introduction of a more worthy ANC leadership and a stronger opposition party to address the burning issues including the independence of the SA financial ministry and Reserve Bank, State Owned Enterprises and Education.

At FIRSTGLOBAL we are cautiously optimistic about a better year for markets and that our portfolios will continue to outperform.

In this bumper issue, we trust that you enjoy reading two very topical and relevant items regarding "Low volatility investing", something we have seen more of in recent times, as well as an "investment case for investing in emerging markets" while being mindful of the fact that South Africa is very much part of emerging markets, albeit a very small part.

In addition we provide a useful overview of the Fund of Funds concept largely used by FIRSTGLOBAL and often misunderstood by investors. We also commence with a TWO PART series on private retirement funds.

We wish you and yours a wonderful 2017 in all aspects of life!

John Swart

## Retirement funding for private individuals* (part 1)

**Edrich Jansen | (M Com) UP | Junior Analyst | FIRSTGLOBAL Asset Management**

***"Private individuals" in this context refers to persons who are not members of a compulsory pension or provident fund as required by their terms of employment. Typically, these will be individuals responsible for their own retirement funding and will include professionals in private practice, sole operators and small business directors/shareholders without a company retirement fund – generally referred to as self-employed.**

How much money do I need to retire comfortably? How can I guarantee that I retire with peace of mind? These are undoubtedly questions you have asked yourself, and if you have not, you should!

The only certainty in life is that nothing is certain, except of course for death and taxes. To successfully navigate your path to retirement, you should arm yourself with goals and implement plans to reach these goals. A good starting point is to empower yourself through financial education and familiarise yourself with the various options available to you. In this article, attention is given to the different types of private retirement investment products, the differentiating factors between each, their legal structures as well as the relevant tax legislation applicable to each.

A private retirement product is a tax-effective investment vehicle that provides an individual with an income stream in the form of an annuity upon retirement. The different types of retirement products an individual can choose from include a retirement annuity (RA), an investment linked living annuity (ILLA) and a preservation fund. All three of these options have variable tax and annuatisation characteristics, but government has recently signed into law reforms in an attempt to make matters less complicated. Let us delve a little deeper into each option.

## Retirement Annuity (RA) and Preservation Funds

The primary target market for RAs is individuals who are either self-employed or their employer does not provide a pension or provident fund. Additionally, if you earn significant amounts of passive income (rent, interest etc) and you want to increase your retirement savings, a RA is a suitable solution.
A preservation fund on the other hand can be seen as a "parking bay" for your retirement savings when you leave your employer in the event of resignation, dismissal or retrenchment. Besides the different design of the products, there are other differences between a RA and a preservation fund, which you should be aware of to help you decide which one is more suitable for your circumstances.

With a RA, you can contribute on a regular basis, but preservation funds will only accept transfers from other funds. You cannot withdraw your benefits from a RA before retirement (minimum retirement age is 55) unless you emigrate, whereas you are allowed one (full or partial) withdrawal from your preservation fund at any time before retirement. Regarding retirement benefits, you can elect to receive your entire fund balance as cash if you are a member of a provident preservation fund, but you can receive only one-third as cash if you are a member of a RA or pension preservation fund, the remaining two-thirds must be used to buy a compulsory annuity income. A factor that is sometimes overlooked is the costs associated with investing in preservation funds, which is generally lower than RAs.

Even though RAs and preservation funds differ in legal structures, their tax benefits are very closely aligned. Since no contributions are made into preservation funds, the first tax benefit listed below does not apply, but the remaining tax benefits are applicable to both RAs and preservation funds.

**Tax benefits:**

- You may deduct up to 27,5% of your gross remuneration or taxable income (whichever is the higher) in respect of your total contributions to a RA, subject to an annual limit of R350,000
- Investment returns earned within these retirment funds are tax free, i.e. no income tax or capital gains tax are applicable
- Benefits are taxed on a favourable basis – lump sum benefits are taxed on a sliding scale with a portion of the benefit tax free (see table below).

| Tax Rate | Withdrawal Lump Sum | Retirement Lump Sum |
|---|---|---|
| 0% | 0 – R25,000 | 0 – R500,000 |
| 18% | R25,001 – R660,000 | R500,001 – R700,000 |
| 27% | R660,001 – R990,000 | R700,000 – R1,050,000 |
| 36% | R990,001+ | R1,050,001+ |

" A preservation fund can be seen as a 'parking bay' for your retirement savings when leave your employer."

## Investment Linked Living Annuity (ILLA)

In contrast to the aforementioned options, a living annuity (LA) places the responsibility of securing an adequate income firmly on your shoulders. You have the flexibility to choose your investment portfolio and switch providers should you wish to do so. By law you are required to draw an income of between 2.5% and 17.5% of your investment value per year, but you are allowed to change this percentage on an annual basis. The biggest risk to an ILLA is if the investments you choose perform poorly and the level of the annuity that is withdrawn exceeds the growth of the underlying investment, which will ultimately lead to the erosion of your capital. Without proper planning and foresight, the possibility of outliving your savings becomes a reality.

Members of retirement funds (RA, pension fund, provident fund, pension preservation and provident preservation fund) do not enjoy freedom of testation over their retirement benefits, since they do not form part of their estate. Upon the death of the member, the benefits will be allocated towards the member's financial dependents at the discretion of the trustees, with the primary beneficiaries typically being the surviving spouse and any minor children. The trustee discretion however falls away if there are no dependents, in which case the trustees must pay the benefit to the nominated beneficiaries. If there are no nominated beneficiaries, the money will fall into the member's estate.

It is impossible to explain all the intricacies of the various retirement funding options for private individuals in an article, but it should at least give you an indication of what your options are and the tax benefits associated with these products. Clients are advised to always obtain professional advice when it comes to retirement planning and the election of options followed by sensible investment and management thereof.

" A living annuity places the responsibility of securing an adequate income firmly on your shoulders."

**In Part II of this article, we will compare ILLA's with a typical pension fund and explain ILLA's in more detail by way of examples.**

# Demystifying FUNDS OF FUNDS

Jacy Harington | BCom (Hons) Cum Laude; CFA | Co-Portfolio Manager | FIRSTGLOBAL Asset Management

**A fund of funds (FOF) is an investment strategy of holding a number of collective investment portfolios rather than investing directly in stocks, bonds or other securities.**

A common misinterpretation in the market is the interchangeable use of the terms fund of funds and multi-manager funds. Where the term fund of funds specifically relates to the fund of collective investment portfolios, multi-manager funds, on the other hand, invest in funds that are not collective investment portfolios but rather investment portfolios that are being specifically managed for the multi-manager.

## Why a fund of funds?

When one looks back over the history of how funds of funds came into being, it can partly be ascribed to the changes within the regulatory environment governing financial advisors. It was also, however, driven by the need for greater product uniformity to serve as investment solutions specifically tailored to suit clients' risk profiles and their investment needs.

Before the fund of funds product origination, financial advisors could only manage each client's portfolio separately and often relied on wrap funds structures through which a model portfolio could be constructed across all of their clients' portfolios. Over the years, and even today, a large number of financial advisers and investment brokers still select individual funds at their own discretion, mostly lacking any formal process and exposing their clients to excessive risk and ultimate under-performance.

Wrap funds, fast becoming extinct, do allow for a process of manager and fund selection but they trigger a capital gains tax event every time the wrap fund manager (or committee) decides to switch out of one fund into another. Another drawback of wrap funds is that their structure does not allow management to bulk up their total underlying fund position across all of their individual client portfolios, and so negate any of their bargaining power with the fund managers in which the wrap funds are invested. This results in investors losing any benefit in fund pricing that could have been obtained through combined scale.

## FAIS and fund of funds

It was, however, in 2004 during the implementation of the Financial Advisory and Intermediary Services (FAIS) act when another potential problem with wrap funds came to light. The FAIS Act places the responsibility on the financial advisers to undertake the necessary care and diligence in rendering financial services in the best interest of the client. The proposition of fund of funds resolves this potential risk, as it carries out its own due diligence and so provides support and direction to the advisor to fulfil their duty in the best interest of the clients as instated by the FAIS Act.

## FIRSTGLOBAL ASSET MANAGEMENT (FGAM)'s investment process

FGAM's investment process illustrates this due diligence. The process starts off with the initial screening of the fund universe where certain funds that do not meet certain criteria such as size and minimum track record are excluded. After the initial screening, possible fund opportunities are further analysed in the quantitative process. Quantitative analysis comprises the analysis of relevant markets and funds by means of complex mathematical and statistical modeling. Funds that are identified through our quantitative process are then included on a short list that will be subjected to further qualitative analysis.

Qualitative analysis comprises the analysis of funds that use subjective judgment based on unquantifiable information, such as management expertise, industry cycles, strength of research and development, and depth of the management team. The qualitative process includes regular fund manager meetings with the FGAM investment committee who provide the forum to raise any questions or concerns with the fund management team. Once this process is completed, funds are then added to the watch list which makes them eligible for inclusion in the FIRSTGLOBAL fund range as part of the construction process. The decision to include a fund within any of FGAM's specific fund of funds is also dependent on the asset allocation positioning of the fund as a whole, together with the diversification benefits and interaction of all the underlying funds in order to maintain the overall risk profile of the fund.

FGAM is committed to constantly monitoring changes and to taking decisive, reasoned actions to ensure that the FIRSTGLOBAL funds and underlying portfolios are meeting their investment objectives. This monitoring process is ongoing and provides peace of mind that the funds remain in line with their risk and return objective as prescribed in their mandate.

Since fund of funds were first introduced to the South African investor, there has been an ongoing debate regarding the advantages and the disadvantages of funds of funds as products. Challengers' main point of criticism is that there is an extra layer of fees charged on a fund of funds level by the fund of funds manager, thereby increasing the total expense ratio ("TER"). While this may be true for some funds of funds, it is certainly not the case with FGAM's range of funds. With large fund of funds managers, such as FGAM, the fund of funds management fee is more than offset by the fee discount obtained at the underlying fund management level, made possible through the bulking of assets.

## The benefits of diversification

The key benefit that funds of funds provide is the higher degree of diversification across asset managers, investment styles and asset classes. This reduces investment risk for investors and allows a more stable return profile relative to only having exposure to one single manager. As highlighted before, the diversification provided by fund of funds comes at no additional cost. Another important advantage is also the avoidance of triggering capital gains tax events every time a position in the fund is rebalanced or redeemed, as fund switches within the fund of funds structure are exempt from capital gains tax.

FIRSTGLOBAL Asset Management (FGAM) provides a range of funds of funds covering different risk profiles which, if blended correctly, will address the short to long-term term investment objectives of every client.

The performance track record, breadth of fund research, due diligence, regular reporting and monitoring that have been provided by FGAM since the first funds were launched in 2005, provide clear testimony of the funds of funds' success.

# Greatest anomaly ever, or legitimate building block? …a primer on low volatility strategies

Jason Swartz | M.Bus.Sc, CFA Charterholder | Investment Strategist | Satrix

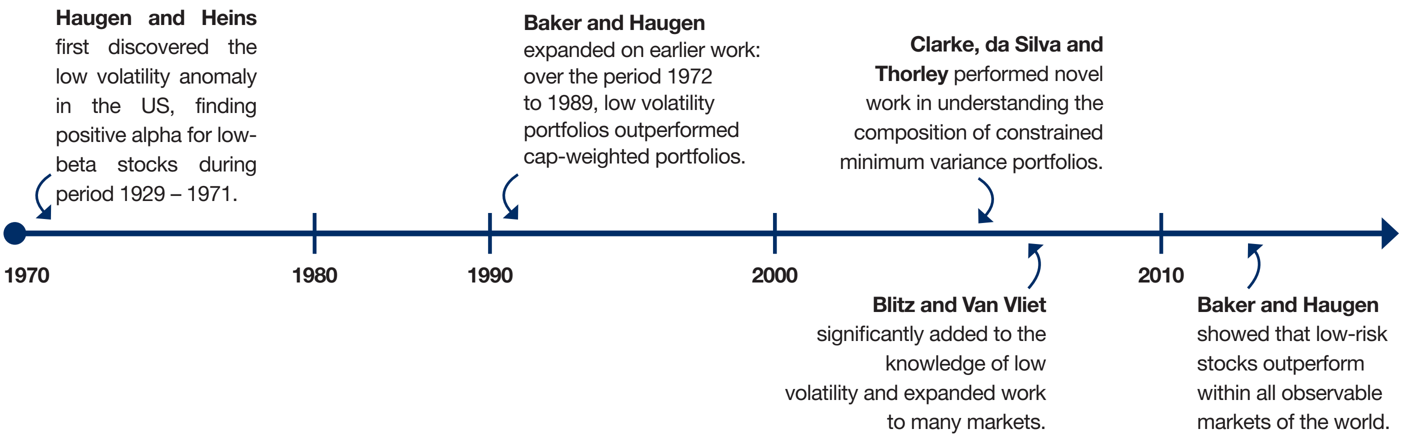
## Introduction to low volatility strategies and how they can practically be used as an essential component of your investment strategy

**Conventional wisdom is that high risk equals high return.** In an asset class sense this is true: equity markets – which have significantly higher fluctuations than bond markets – have generated superior long-term returns due to exposure to the equity risk premium. Within equities too, finance theory[1] will tell you that having a high exposure to risk will reward you, i.e. that high volatility stocks have a higher than expected return than low volatility stocks.

There's only one problem with this theory: **it just can't seem to fit the data.**

The puzzling fact – that over a long term horizon, low volatility stocks outperform the market (as well as high volatility stocks) – is probably one of the greatest anomalies in modern finance. The empirical evidence has been clear since the earliest academic research on the low volatility anomaly back in the 1970s, and since then both academic and practitioner researchers have shown that the anomaly is evident and persistent across a range of different geographic regions. Despite the extensive research, a single well-accepted explanation still remains elusive.

## Figure 1: Significant research in the evolution of low volatility strategies




Source: Satrix | December 2016

Over the last few years, **low volatility strategies have attracted significant investor attention,** particularly after the global financial crisis where the appreciation for diversification has increased. To this end, investment providers globally have been launching low volatility indices to exploit the low volatility phenomenon, with the uptake in assets directed at these strategies still growing rapidly.

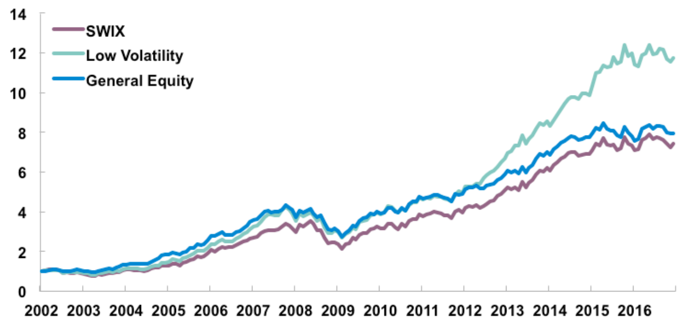
Domestically, low volatility strategies haven't gained the same traction seen offshore. In our view the scarcity of appetite can largely be attributed to the lack of understanding of the role and characteristics of these portfolios, as well as the reasoning behind the premium, which we aim to detail in this note. Ultimately, based on our analysis, **South Africa is a fertile ground for this strategy** to serve a specific investment purpose to client portfolios, when well risk managed.

To illustrate this, we have reconstructed a practically investable low volatility portfolio[2] from 2001 to 2016, rebalanced quarterly. We also compared the performance to the SWIX as a benchmark, as well as the average ASISA General Equity category of funds as a proxy for active manager performance.

1 The Capital Asset Pricing Model (CAPM) says that a stocks' expected return is directly proportional to its beta or market risk. Or in other words, higher-risk stocks should be rewarded with higher expected returns while lower-risk stocks receive lower expected returns.

2 We utilise Clarke, De Silva and Thorley's [2006] a nalytical solution (which in our view is the simplest and most intuitive of current approaches) to inform the signal for the low volatility portfolio. Thereafter we perform an optimisation within Barra Portfolio Manager subject to constraints. For details on the portfolio construction process and risk management overlays, please contact us and we will gladly share this information.

## Figure 2: Cumulative performance and risk statistics of low volatility, SWIX and General Equity funds (2001 to 2016)




| | | Low volatility | General Equity category | SWIX |
|---|---|---|---|---|
| Volatility | | 13.8 | 14.2 | 15.9 |
| Return to risk ratio | | 1.24 | 1.03 | 0.89 |
| Maximum drawdown | | -39 | -43 | -47 |
| Average monthly | Up | 3.3 | 2.8 | 3.0 |
| return when SWIX is: | Down | -1.7 | -2.1 | -2.7 |

Source: Barra | Satrix calculations | December 2016

## Characteristics of a low volatility strategy

One of the main characteristics of a low volatility strategy is its ability to **protect performance during deep correction cycles**, providing lower drawdowns to portfolio outcomes. Nonetheless, we see that this protection doesn't come at a cost to up-cycles[3] as the strategy's performance during up-markets has also been compelling. Ultimately, our findings are that domestic markets lends themselves particularly well to low volatility portfolios, **delivering superior long term risk-adjusted excess returns.**

## Making the best use of low volatility strategies

These strategies are suitable to investors who are seeking equity exposure with lower risk compared to traditional equity portfolios. That being said, we would either recommend this for non-benchmark cognisant investors, or as a core component of a well-diversified portfolio (i.e. not for investors to use in complete isolation) owing to generally higher than average tracking errors (6% to 10%). While low volatility may produce strong information ratios[4], the strategy is best evaluated on an absolute risk-adjusted basis e.g. using a 'return to risk' ratio or Sharpe ratio.

It is also vitally **important to understand the nature of risk exposures** of a low volatility portfolio. One of the fiercest criticisms of low volatility portfolios in the investment community is that they generate structural factor exposures (particularly value and size), or structural sector biases. In our example above, we have neutralised these risk exposures while still delivering the low volatility premium. Other criticisms include higher trading costs, limited capacity, limited upside capture, concentration and valuation risk, all of which can be mitigated by strong risk management expertise of the investment manager providing the low volatility solution.

3 We do not expect this asymmetric return outcome generally, but would expect that the underperformance during an up cycle be more than compensated by the outperformance during a down cycle.
4 The information ratio is a ratio of portfolio returns above the returns of a benchmark to the volatility of those returns. This measures the consistency of the portfolio's ability to generate excess returns relative to a benchmark

## Will the low volatility effect persist?

The most common explanations of the low volatility phenomenon is due to:

- A focus on tracking error instead of total risk by market participants, thereby making low volatility stocks less attractive. *We believe the importance of benchmarking will keep this factor intact*.
- As many investors are unwilling (or not allowed) to apply leverage in their portfolios, return-seeking investors tend to prefer stocks with high risk. *Due to regulation, we don't believe this factor will change.*
- The lottery ticket effect, whereby a large number of risk-seeking investors buy volatile stocks to get rich quickly, and neglect low volatility stocks which tend to have a longer investment focus. T*his is a behavioural effect which is structural in nature.*

## The future of low volatility

Today low-volatility investing has gained broader acceptance within academic circles, but more importantly also among investors. The key to the continued interest from investors lies in the ability of the investment provider to make the theory of low volatility investing practical, and to have the expertise to understand and control all the sources of risk in the portfolio. This is particularly true in the wake of the series of financial crises that started in 2008, which has since seen investors become more open to alternative ways of capital preservation and diversification.

**"The puzzling fact – that over the long term, both low and high volatility stocks outperform the market – is probably one of the greatest anomalies in modern finance."**

# Why emerging markets are essential to any equity portfolio

**Adapted from the article 'World-beating investment returns: Emerging markets win over two decades' | Srinivasan Sivabalan | Bloomberg | 2017**

## If you want superior returns, including emerging markets in your portfolio is essential

According to data from Bloomberg, the top 10 stock indexes that delivered the best returns in 2016 were all emerging or frontier markets. What's more, over the past 20 years, 9 out of 10 best-performing equity gaugegs have been in developing nations. This indicates that including emerging markets in your portfolio – or your clients' portfolios – is essential if you want superior returns from your equity investments year after year.

## The data proves many of the preconceptions that investors have about emerging markets wrong

The general perception is that emerging markets are riskier because their higher returns come with greater market and currency volatility. However, if we take a closer look at the data, the flaws in these perceptions are evident. Certain data sets show that investors make more money in emerging and frontier markets on a volatility risk-adjusted basis.

The table below shows that emerging markets dominate the positions as top stock markets, even when the gains are converted into US dollars. Brazil was the best equity market in dollar terms in 2016, with its benchmark index gaining 69%. When we consider volatility-adjusted returns, Kazakhstan came out on top. Pakistan (which will formally upgrade to an emerging market from a frontier nation at MSCI this year) came in second. The last time wealthy nations dominated the list of equity gainers was in 1998, when emerging markets were shaken by the Russian debt default and the aftermath of the Asian currency crisis. That year, the number one market in dollar terms was Greece, which was downgraded to an emerging market by MSCI in 2013.

## The stellar performance, however, does not mean that every emerging market is a top performer

Although the data provides clear evidence that emerging markets rightfully deserve a position in top equity portfolios, it is crucial to interpret the data correctly. The data shows that most top-performing stock markets are emerging nations; it does not claim to state that every emerging market is a top performer. In fact, the data also shows that the developing world dominates the list of markets that have made the biggest losses.

## A carefully selected portfolio of emerging markets offers the potential of rewarding returns

The MSCI Emerging Markets Index trades at 12.1 times the projected earnings of its members, 26% lower than the price-earnings ratio for the MSCI World Index. According to Julian Mayo, Co-Chief Investment Officer at Charlemagne Capital Ltd in London, there are sufficient indicators that emerging markets may continue their winning run in 2017. Mayo believes developing nations will benefit from higher earnings expectations, expanding growth differentials with wealthy nations, and more disciplined capital spending by companies. If Mayo is right, a careful selection of investments with emerging market exposure may provide superior returns this year.

| | 1st | 2nd | 3rd | 4th | 5th | 6th | 7th | 8th | 9th | 10th |
|---|---|---|---|---|---|---|---|---|---|---|
| 1997 | Oman | Turkey | Russia | Botswana | Hungary | Mexico | Switzerland | Portugal | Greece | Kuwait |
| 1998 | Greece | South Korea | Spain | France | Nether-lands | Portugal | US | Germany | Morocco | Switzerland |
| 1999 | Turkey | Russia | Malta | Indonesia | South Korea | Mexico | Finland | Japan | Greece | Egypt |
| 2000 | Vietnam | Mongolia | China | Nigeria | Latvia | Jamaica | Denmark | Bulgaria | Tunisia | Saudi Arabia |
| 2001 | Russia | Mongolia | Latvia | Qatar | Botswana | Jordan | South Korea | Slovakia | Kuwait | Nigeria |
| 2002 | Pakistan | Romania | Bulgaria | Estonia | Kuwait | Russia | Czech Republic | Qatar | Hungary | Slovakia |
| 2003 | Bulgaria | China H | Lithuania | Brazil | Thailand | Argentina | Turkey | Kuwait | India | Chile |
| 2004 | Dubai | Romania | Egypt | Monte-negro | Colombia | Slovakia | Saudi Arabia | Czech Republic | Lithuania | Hungary |
| 2005 | Montenegro | Kazakhstan | Dubai | Egypt | Colombia | Lebanon | Saudi Arabia | Russia | Kuwait | Mongolia |
| 2006 | Kazakhstan | Peru | Vietnam | China | Cyprus | Mongolia | Montenegro | China H | Serbia | Morocco |
| 2007 | Mongolia | Zambia | Monte-negro | China | Slovenia | Nigeria | Croatia | Mauritius | Turkey | Brazil |
| 2008 | Tunisia | Ghana | Laos | New Zealand | Morocco | Slovakia | Lebanon | Jordan | Japan | Qatar |
| 2009 | Brazil | Russia | Sri Lanka | Peru | Indonesia | Norway | Turkey | Argentina | Chile | India |
| 2010 | Mongolia | Sri Lanka | Peru | Ukraine | Estonia | Thailand | Indonesia | Chile | Argentina | Philippines |
| 2011 | Mongolia | Zambia | Jamaica | US | ilippines | Indonesia | Qatar | Mauritius | New Zealand | Malaysia |
| 2012 | Turkey | Egypt | ilippines | Estonia | Nigeria | Thailand | Kenya | Pakistan | Greece | Laos |
| 2013 | Dubai | Abu Dhabi | Bulgaria | Nigeria | Kenya | Ghana | Argentina | Ireland | Pakistan | Finland |
| 2014 | China | Pakistan | Egypt | India | Sri Lanka | ilippines | Argentina | Indonesia | Turkey | Qatar |
| 2015 | Jamaica | Latvia | Hungary | Denmark | Malta | Slovakia | Ireland | Japan | Estonia | China |
| 2016 | Brazil | Kazakhstan | Peru | Russia | Pakistan | Namibia | Hungary | Morocco | Colombia | Bulgaria |

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